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Ethiopia's New Financial Sector and Its Regulation

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Abstract

Ethiopia is one of a number of SSA economies that adopted state-led development strategies in the 1970s (others include Angola and Mozambique), and suffered from intense conflict (leading to the fall of the Derg regime in 1991). The new government was therefore faced with the twin tasks of reconstructing the economy, and embarking on the transition to a market economy. As part of this process, state banks have been reorganised, the role of the private sector in the financial system has been expanded, interest-rate controls have been liberalized, and the central bank has been given new powers of financial supervision. Financial reform has been gradual, but nevertheless determined despite disagreement with the IMF over restrictions on the entry of foreign banks and the role of the largest state bank. …/…

Keywords: sub-Saharan Africa, Ethiopia, conflict, economic reform

JEL classification: O10, O55

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This paper argues that gradual financial liberalization—while simultaneously investing in regulatory capacity—is the appropriate strategy for maintaining macro-economic stability and growth in Ethiopia. In this regard, the Chinese transition strategy—in which significant control was retained over the financial sector—can be a useful guide to strategy design in SSA, provided that rent-seeking can be contained.

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1 Introduction

Successful reconstruction and development both require financial institutions capable of mobilizing resources, in particular domestic savings, and channelling them into high-return investments. But, as the case of Ethiopia shows, the creation of a sound financial system together with an appropriate regulatory framework is not a straightforward task. During the era of state socialism (1974 to 1991), Ethiopia's financial institutions were charged with executing the national economic plan; state enterprises received bank finance in accordance with the plan's priorities. This system, based on the template of the Soviet Union, saw little need to develop the tools and techniques of financial regulation and supervision found in market-based financial systems. With the overthrow of the Derg Regime in 1991, Ethiopia began its transition to a market economy. This transition has had profound implications for the financial system. New financial institutions have emerged, the role of the private sector in the financial system has been expanded, and the role of the central bank is being reformulated.

The government's strategy for financial development is characterized by gradualism—the financial sector currently consists of a mix of private and public entities—and a strong emphasis on maintaining macro-economic stability. This is in contrast to Mozambique, where state banks were rapidly privatized (Addison and de Sousa 1999). Private banks and insurance companies have been incorporated alongside restructured state banks in Ethiopia, and interest rates have been liberalized in two stages. Simultaneously, the strategy has aimed to strengthen domestic financial capacity as well as the central bank's capacity for prudential regulation and supervision before further liberalization is enacted. In contrast to Mozambique, restrictions on the entry of foreign banks have been retained. In the eyes of the IMF this strategy is too slow. However, the unsatisfactory transitions in Eastern Europe and the Former Soviet Union (FSU) and financial distress following liberalization elsewhere in the world (most recently in Asia) highlight the dangers of rapid financial liberalization when regulatory frameworks are still underdeveloped.

This paper explores the issues. It begins, in section 2, by setting out the main features of Ethiopia's financial development prior to 1991, focusing in particular on the policies of the Derg. This sets the scene for the summary and analysis in section 3 of the financial reforms undertaken so far. Section 4 considers important regulatory issues, and section 5 discusses second-phase financial reforms. Section 6 focuses on the critical issue of reform speed and sequencing. Section 7 concludes by highlighting the relevance to Ethiopia of different types of transition strategy, including that of China.

2 Financial development prior to 1991

The establishment of the Abyssinian Bank in 1905 marked the start of modern banking in Ethiopia. The financial sector was dominated by foreign ownership until the Abyssinian Bank was nationalized in 1931 and renamed the Bank of Ethiopia, thereby becoming the first bank to be nationally owned in Africa (Belay Gedey 1990: 83, Befekadu Degefe 1995: 234). Further financial institutions were established during the Italian occupations of the late 1930s. In 1943 the State Bank of Ethiopia was founded, despite considerable British opposition (see Befekadu Degefe 1995, for an interesting neo-colonial story). Resistance to foreign control of the financial system has therefore been a longstanding theme in Ethiopia's banking history, and it is still an influence today.

The State Bank of Ethiopia operated as both a commercial and central bank until 1963 when it was dissolved to form the central bank, the National Bank of Ethiopia (NBE), and the Commercial Bank of Ethiopia (CBE). A number of other private financial institutions were also established during the 1960s. The structure of Ethiopia's financial system therefore resembled that of other African countries at this time.

All of this changed with the overthrow of the monarchy of Haile Selassie in 1974. Under the Derg regime all privately owned financial institutions including three commercial banks, thirteen insurance companies and two non-bank financial intermediaries were nationalized on 1 January 1975 (Befekadu Degefe 1995: 273, Harvey 1996). The NBE continued its functions as a central bank, although the directives of the planning system now circumscribed its activities. The NBE fixed both deposit and loan rates (both of which were set at very low levels), administered the allocation of foreign exchange (all of which had to be surrendered to NBE), and directly financed the fiscal deficit (NBE 1996a). NBE's bank supervision and regulation was largely restricted to off-site inspection of a few bank branches.

By allocating credit and foreign exchange in favour of the state sector, NBE constituted a powerful tool for imposing state-led development. Credit to the private sector fell from nearly 100 per cent of total bank credit under the monarchy to only 40 per cent under the Derg (Di Antonio 1988). The Agriculture and Industrial Development Bank (known today as the Development Bank of Ethiopia) allocated 68 per cent of its resources to State farms (Di Antonio 1988: 74). State banks undertook little in the way of any financial or economic analysis of prospective projects. Since loan collateral was not required from state-owned enterprises (SOEs) and the government implicitly covered losses by fiscal subventions, state banks developed very little capacity to appraise the riskiness of their balance sheets. Moreover, the inefficiency of the state financial system manifested itself in excess liquidity; the ratio of liquid reserves to CBE's total net deposits averaged 25 per cent during this time (IMF 1999b: 28).

3 Economic transition and financial reform

With the fall of the Derg in 1991, the new government faced the difficult tasks of organizing the demobilization as well as starting the transition to a market economy. There is a considerable literature on the policy changes enacted since 1991 to which the reader is referred (see for instance Hansson 1995). Here, we confine ourselves to summarising the main characteristics of the transition in order to place the financial reforms in context.

Economic reform began soon after the new government took power. War and the Derg's policies had left a crippled economy and an impoverished people. Fiscal policy aimed to raise revenue and to reduce the fiscal deficit as a source of inflation. Structural reforms concentrated on lifting most domestic price controls, reducing import tariffs, and moving to a market-based system of foreign exchange allocation.

Exchange-rate reform, which was an essential first step in achieving economic recovery, began in October 1992 with a devaluation of 140 per cent from 2.07 Birr to the dollar (the rate at which it was fixed for nearly two decades) to 5 Birr to the dollar. The devaluation's size was justified by the substantial premium on the parallel market, which was 238 per cent at one point. A foreign exchange auction system was introduced in 1993 (Aron 1998). The auction-system initially worked alongside the official (fixed) exchange rate which applied to critical imports and external debt-service, but the system was further liberalized over 1993-96. Once export earnings had recovered sufficiently the negative import list was abolished and controls requiring the surrender of foreign exchange were liberalized. Reform of the exchange and trade system corrected major policy distortions of the Derg era, in particular by removing the disincentive to produce exportables inherent in the pre-1992 currency overvaluation.

Ethiopia has received large aid inflows in support of its reconstruction and transition programmes; the country was the largest World Bank client in SSA in 1998. The early reforms were supported by a World Bank structural adjustment credit (SAC) and an IMF Enhanced Structural Adjustment Facility (ESAF) over 1993 to 1995. A second ESAF was launched in 1996, but ran into trouble in 1997, before resuming in 1998 (see section 5).

The economy has responded reasonably well to reform despite the structural constraints characteristic of a predominantly agrarian economy (large annual fluctuations in GDP occur in response to weather variations), terms of trade shocks (the decline in the coffee price) and the 1998-2000 war with Eritrea (Table 1 shows the main trends). Fiscal and monetary policy have kept inflation low, and exchange rate and trade reforms have stimulated exports (IMF 1999a). However, the external deficit has nevertheless deteriorated with the rise in imports (related to reconstruction), and the alarming deterioration in debt-service made Ethiopia a candidate for official debt-relief under the Heavily Indebted Poor Countries (HIPC) initiative.

Table 1

Ethiopia: major macroeconomic trends

	1991/92	1992/93	1993/94	1994/95	1995/96	1996/97	1997/98	1998/99
Real GDP growth rate (%)	-3.6	12	1.6	5.2	12.7	5.6	0.5	9.4
Inflation Rate (%)	21	10	1.2	13.3	0.9	0.8*	2.3*	na
Exchange Rate, Birr/US$ (Average Marginal rate)		5.01	5.77	6.25	6.32	6.47	6.80	na
Exchange Rate, Birr/US$ (Average Parallel Market rate)		7.6	7.05	7.30	7.64	7.16	7.23	na
Exports to GDP ratio (%)	4.51	8.33	11.38	14.32	13.08	15.53	15.02	na
Imports to GDP ratio (%)	10.69	16.95	21.5	24.06	25.62	26.34	28.38	na
Debt to GNP ratio (%)**	63.9	65.7	157.6	208.5	180.3	168.9	159	na

* These data are based on the new nationwide consumer price index. Previous inflation data is based on the Addis Ababa retail price index.

** Based on World Bank (1999) including Ruble denominated debt.

Sources: Alemayehu Geda and Daniel Zerfu (1998), Alemayehu Geda (1999) MEDaC (1998), and World Bank (1999).

3.1 The new private banks

Financial reform began in earnest in 1994. NBE's role in overseeing the commercial banks was codified. Sector-specific interest rates administered by NBE were also ended, and replaced with a minimum deposit rate (10 per cent) and a maximum lending rate (15 per cent). The domestic private sector was permitted to enter the banking and insurance business (foreign financial institutions are not yet permitted to invest). The response to these reforms has been promising. There are now 6 private banks; the largest, in terms of paid up capital, is the Wegagen Bank (established 1997), followed by the Awash International Bank (established 1994). There are also 8 private insurance companies; Nyala Insurance (established 1995) has the largest number of branches.

The market shares of the private banks, although growing, still remain small relative to those of the publicly owned CBE (see Tables 2 and 3). CBE dominates the deposit market (its share was 87.6 per cent in 1995/96) a reflection of CBE's national coverage and its role as banker for many SOEs. However, CBE's dominance in the loan market has eroded, its share having fallen to 56.3 per cent from 83.9 per cent in 1995/96 (Table 3). Indeed, the absolute level of CBE loans fell by 24.7 per cent between 1995/96 and 1997/98 (see Table 4). Another public institution, the Development Bank of Ethiopia, has captured some of this share, but the new private banks have raised their share to 17.3 per cent (Table 3). The Awash International Bank has been especially successful; its lending now exceeds that of the state-owned Construction and Business Bank (Table 4). Nevertheless, the market dominance of CBE has proved to be a contentious issue, and one that we return to in section 5.

Table 2

Ethiopia: distribution of total deposits in the banking system (percentage shares)

	End of Fiscal Year		
	1995/96	1996/97	1997/98
Commercial Bank of Ethiopia	93.2	91.6	87.6
Development Bank of Ethiopia	0.1	0.3	3.6
Construction and Business Bank	3.65	4.0	3.2
Private Banks	3.0	4.2	5.6

Source: MEDaC (1998).

Note: The private banks consist of: Awash International Bank, Dashen Bank S.C., Bank of Abyssinia, Wegagen Bank, United Bank S.C.

Table 3

Distribution of total loans in the banking system (percentage shares)

	End of Fiscal Year		
	1995/96	1996/97	1997/98
Commercial Bank of Ethiopia	83.9	73.7	56.3
Development Bank of Ethiopia	10.9	15.7	21.3
Construction and Business Bank	5.12	4.3	4.9
Private Banks	0.0	6.3	17.3

Source: MEDaC (1998).

Table 4

Credit disbursement by banks (in millions of birr and percentages)

	End of fiscal year		
	1995/96	1996/97	1997/98
Disbursement by Source (Total)	*4093.6*	*4002.0*	*4581.3*
Commercial Bank of Ethiopia (Public)	3436.5 [83.9]	2951.2 [73.7]	2586.2 [56.5]
Development Bank of Ethiopia (Public)	447.7 [10.9]	628.9 [15.7]	975.3 [21.3]
Construction and Business Bank (Public)	209.4 [5.1]	171.1 [4.3]	225.4 [4.9]
Awash International Bank (Private)	0	154.7 [3.9]	442.4 [9.7]
Dashen Bank (Private)	0	86.4 [2.2]	121.4 [2.6]
Abyssinia Bank S.C.(Private)	0	9.7 [0.2]	190.6 [4.2]
Wegagen Bank (Private)	0	0	39.8 [0.9]
Share of all the Private Banks		*6.3%*	*17.3%*
Distribution by Borrower (Total)	*4093.6*	*4002.0*	*4581.3*
Public Enterprises	621.0 [15.2]	339.7 [8.5]	163.9 [3.6]
Co-operatives	524.7 [12.8]	510.6 [12.8]	550.3 [12.0]
Private	2947.9 [72.0]	3151.7 [78.8]	3867.1 [84.4]

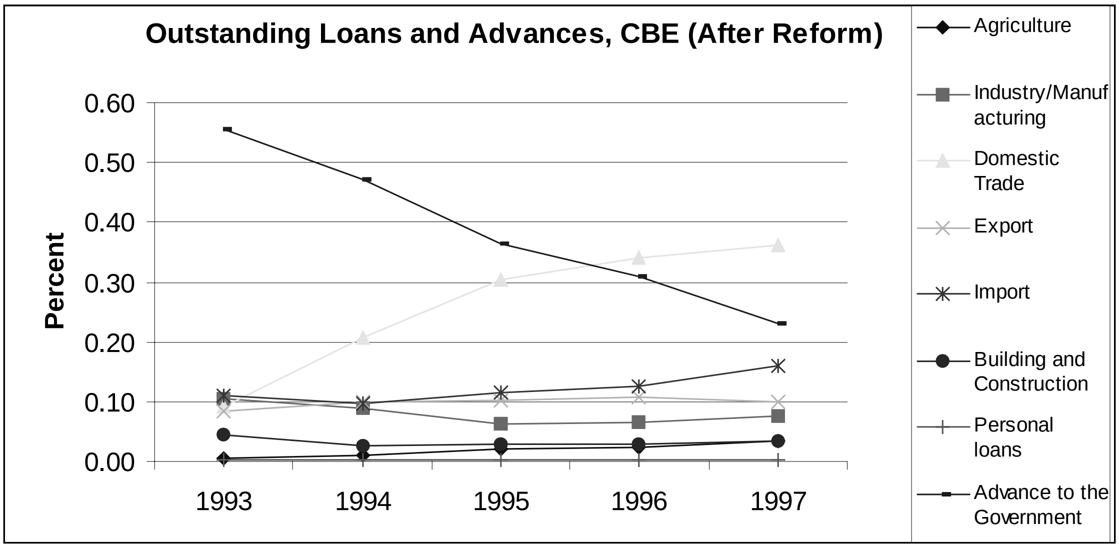
Source: MEDaC (1998) and Author's Calculations.

Note: (Values in square brackets are percentage shares).

Changes on the supply-side of the loan market have been paralleled by important changes on the demand side. Lending to public enterprises has fallen absolutely and as a share of total loans (Table 3). Public enterprises now account for only 3.6 per cent of total bank credit. This reflects the privatization of 197 mostly small- to medium- scale SOEs and 27 large state-owned farms, from 1996 onwards (IMF 1999b). The next phase of privatization will see the divestiture of 110 SOEs, thereby accelerating the decline in the share of bank credit taken by the public sector. Credit demand by the private sector has grown—particularly to finance imports as well as wholesale and retail trade (see Figure 1)—and the private sector's share has risen from a low of 40 per cent during the Derg to over 80 per cent today (Table 4). This reflects the liberalization of business licensing which has encourage private-sector growth, the reduction in import tariffs (thereby raising credit demand to finance imports), and the general upturn in activity as the economy reconstructed between 1991 and 1998. Control of the fiscal deficit has allowed the share of private-sector credit to rise; CBE's credits to the public-sector have fallen substantially (Figure 1) and the share of the private sector in total domestic credit has risen from 12 per cent in 1991 to 54.8 per cent in 1999 (Figure 2).

Figure 1

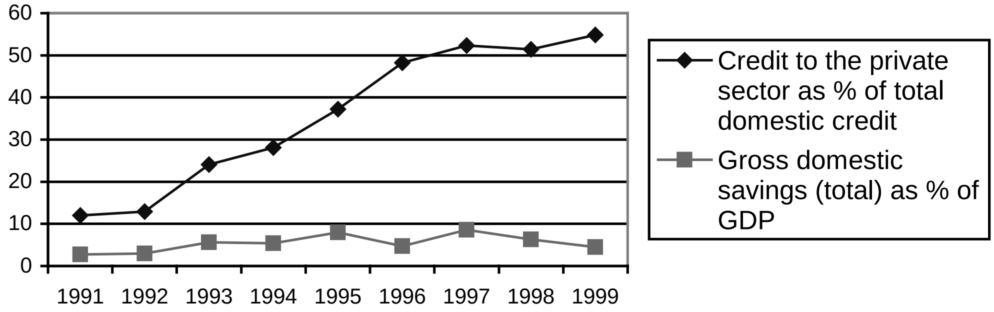
Outstanding loans and advances, commercial bank of Ethiopia (after reform)



Source: Annual Reports and Statistical Review of CBE (various years).

Figure 2

Ethiopia: credit to the private sector and the gross domestic savings rate



Note: Data for 1999 are estimates.
Source: World Bank (2000)

4 Regulating the new financial sector

Financial markets are inherently imperfect, characterized as they are by asymmetric information in the relationship of borrower to lender (Bascom 1994, Stiglitz 1994). In Ethiopia this imperfection is aggravated by the institutional under-investment of the Derg era. Public and private banks are only now developing the capacity to evaluate loan risks in the context of a market economy and are yet to offer the full range of financial instruments required by potential clients (which vary from large commercial enterprises to micro-entrepreneurs). The supporting framework of commercial law and accounting practice—both essential to sound financial systems—are highly underdeveloped in Ethiopia, as in Africa's other transition economies. For these reasons, investment in NBE's capacity to regulate the financial system in the public interest must be a high priority.

Under the Derg, regulation consisted of enforcing interest-rate controls and the allocation of credit and foreign exchange according to the dictates of the planners. Now NBE must learn the skills of prudential regulation and supervision appropriate to a market-based financial system (also the case in Eritrea).[1] This requires the monitoring of capital adequacy and restrictions on bank portfolio choices (to avoid large loan exposures and 'insider lending'). It also requires the imposition of disclosure standards (including the publication of audited accounts), the provision of deposit insurance and lender of the last resort facilities and intervention in distressed banks (Bascom 1994: 170, Polizatto 1993: 173). This is a challenging set of tasks, and the necessary institutions take years to build (see Sheng 1993).

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1 Polizatto (1993: 174) defines prudential regulation as the '... codification of public policy towards banks, while banking supervision is the government's means of ensuring the bank's compliance with public policy'.

In 1996, NBE established a new division to undertake regulation and supervision. Its first task was to draw up a set of guidelines (NBE 1996b). These codify what is expected of banks and of NBE itself. Among its tasks, NBE licenses and approves external auditors to prepare regular accounts for financial institutions; this is important since private-sector capacity in auditing is itself a nascent and therefore inexperienced industry in Ethiopia. NBE's supervision consists of both off-site surveillance and on-site examination.

NBE's off-site surveillance mechanisms require banks to submit key financial data—such as the composition of lending and the scale of non-performing loans—on a regular basis in order to identify all the risks to which each bank is exposed. Commercial banks are legally required to make 100 per cent provision against 'bad' loans (those with no collateral) and 50 per cent provision for 'doubtful' loans (those for which repayment is more than one year late, and for which there is no adequate security). Close attention is paid to credit concentration—over-exposure to a small number of borrowers has undermined many developing financial systems—and the total liability of any one borrower must not exceed 10 per cent of the net worth of the bank according to NBE regulations. This also encourages banks to seek out new customers, an incentive that is important to raising private sector investment and thereby achieving reconstruction.

On the liabilities side, NBE's directives require banks to maintain liquid assets of not less than 15 per cent of their total demand, savings and time deposits with less than one month to maturity. Banks must report their weekly liquidity position to NBE as a further safeguard to protect depositors. The information that NBE collects from its off-site surveillance is used to score the bank on its performance—ranging from 1 (unsatisfactory) to 5 (strong)—and the results are reported to NBE's Governor and its board. Off-site surveillance is only as good as the reports that banks submit to NBE. Therefore NBE also has comprehensive on-site examination powers under which banks are subject to annual inspection, and can be visited at any time without notice.

Therefore on paper, NBE has a comprehensive set of supervisory and regulatory tools at its disposal. However, effective supervision needs considerable human capital investment; Caprio (1996: 4) notes that '... experienced supervisors estimate that it could take many countries 5-10 years of substantial training before their supervisory skills would be near the capacity found in industrial countries'. NBE's supervision department is only three years old and it is short of the necessary human resources. Those abilities are in demand by the private sector itself (including the banks), and therefore ways must be found to recruit and retain experienced staff in NBE (donors, including the IMF, have provided assistance, mainly in the form of training). In consequence, although all banks have been examined on-site since the supervision department's inception, this has not been as frequent as its procedures require. Moreover, the valuation of bank assets has not been a straightforward process. Nevertheless, NBE's supervision division has 'teeth'; in 1997 it pressed CBE to tighten its loan collection procedures, and by 1998 CBE's stock of non-performing loans was down to 24 per cent of total loans compared with 35.8 per cent of total loans in 1996 (GOE-IMF 1998).[2]

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[2] The scale of CBE's non-performing loans is not unusual in transition economies—see Gros and Steinherr (1995: 208) on Eastern Europe and the FSU—reflecting as it does the inheritance of ill-conceived lending from the time of the Derg.

5 The second phase of financial reform

After the 1994 financial liberalization measures, the authorities concentrated their efforts on building regulatory capacity in the financial sector as well as on other priority areas of economic transition, in particular further liberalization of the foreign exchange system and trade liberalization. But financial liberalization accelerated again when loan interest rates were decontrolled in January 1998. A minimum floor on bank deposit rates is retained—6 per cent at present—so that deposit rates remain positive in real terms (inflation is currently about 2 per cent). This floor ensures that the excess liquidity of the banks does not lead them to impose low rates on depositors, thereby undermining the recovery of the savings rate (which rose from 2.7 per cent of GDP in 1991 to a high of 8.6 per cent in 1997, before falling back again to 4.5 per cent in 1999—see Figure 2). The floor can be removed when excess liquidity is finally eliminated.

With a stronger banking system and an improving macro-economic situation, further institutional investment could take place. For example, an interbank foreign exchange market began operation in 1998, enabling banks to manage their foreign-exchange requirements more efficiently. At the same time, a framework was established for an interbank money market, in which banks and non-bank financial institutions can borrow and lend at market-determined rates. This measure should reduce the level of excess liquidity in the banking system; in particular CBE will be able to lend overnight to other banks thereby enabling them to meet any shortfalls in their reserve positions with NBE. The interbank market will facilitate indirect instruments of monetary policy (such as open market operations using government paper) to influence liquidity and interest rates (GOE-IMF 1998).

These steps are crucial to creating a modern, market-based, financial system. Nevertheless two problems arise. First, African inter-bank markets are often dominated by a small number of banks; this can result in oligopolistic practices that reduce market-efficiency and disadvantage smaller, and newer, banks—thereby constraining financial development. In Mozambique, for example, one commercial bank accounts for 70 to 80 per cent of the inter-bank exchange market (Lum and McDonald 1994). It is therefore important for Ethiopia's regulators to closely monitor the efficiency of the new interbank markets. Second, inter-bank transactions are uninsured, thereby creating a systemic risk (Dewatripont and Tirole 1994). Indeed, FSU interbank experiences highlight the dangers for Ethiopia. Former state banks, flush with excess liquidity but inexperienced in lending directly to private enterprises, lent instead to new private banks in the belief that this was less risky (Roe *et al.* 1998: 18). But the poor quality of the loan portfolios of the new banks exposed the large banks to as much risk as direct lending, and the interbank market spread financial distress throughout the system. Africa's banks and their regulators can therefore learn much from the problems encountered in the FSU's financial transitions. Effective implementation of NBE's code of conduct for the new interbank markets will be critical to financial stability.

5.1 Disagreement with the IMF

The second phase financial reforms took place against a background of disagreement between the IMF and the government over the financial sector. This led to the suspension of the second ESAF in October 1997 (the World Bank and the bilateral donors continued to disburse). IMF criticism focused on two major issues. First, the IMF argued that CBE's share of the deposit and loan markets (see section 3) constrained competition; the Fund wanted CBE split up into three or four banks for privatization. Second, the Fund pressed the government to open the market to foreign banks, citing the example of Mozambique. Limitations on the operation of foreign exchange bureau were another source of disagreement.

The dispute was finally resolved with the announcement of further reforms in September 1998. The resulting Policy Framework Paper (PFP) sets a target to reduce CBE's non-performing loans to 15.4 per cent of total loans by the end of 1999 (GOE-IMF 1998). This continues the progress made since NBE's 1997 examination of CBE which reduced CBE's non-performing loans to 24 per cent of total loans (see section 4). CBE's compliance with NBE regulations is being tightened up, and its capital and reserves are to be increased.

An external audit of CBE was also agreed, and this audit will guide further restructuring, although what form this will take is presently uncertain; the IMF continues to press for CBE's break up and privatization. The government has agreed to the privatization of the Construction and Business Bank—the second largest commercial bank—but remains wary of privatizing CBE. It cites the improvement in CBE's performance since the NBE examination and the erosion of CBE's dominance in the loan market (Table 3 shows a fall in CBE's market share to 56 per cent from nearly 84 per cent in 1995/96).

Certainly experience elsewhere indicates that privatization does not automatically improve performance; the 1998 scandal involving the Uganda Commercial Bank is a case in point. Moreover, the World Bank's experience of financial reform in the FSU leads Roe *et al.* (1998: 8) to the conclusion that early privatization does little to improve the quality of the banking system and may be counterproductive when institutions are weak and prudential regulation is underdeveloped. Therefore it is by no means self-evident that Ethiopia should follow Mozambique's example of privatizing state banks early in the transition.

The issue of opening the financial system to foreign banks remains on the table. The benefits of opening include recapitalization of the banking system (a strong motivation for opening to foreign banks in Angola and Mozambique) and the transfer of modern banking technologies.[3] However, although some (but certainly not all) foreign banks have considerable 'reputational capital'—and may therefore transfer high standards to Ethiopian partners—they can introduce new risks (such as excessive and unhedged short-term foreign borrowing) which the central bank has little experience in containing. Moreover, NBE faces considerable pressure in effectively supervising the financial system as it stands. At present, the procedures of the restructured state banks and the private banks are similar to those of CBE with which NBE supervisors are familiar. NBE also needs to build its capacity to grade the quality of foreign banks; some poor-quality Asian banks have set up in Africa's transition economies. Hence, the authorities are understandably cautious in opening up to foreign banks with unfamiliar procedures and potentially doubtful reputations.

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3 For Africa the percentage of total bank assets owned by foreign banks ranges from zero in Ethiopia to 32 per cent in Tanzania and 100 per cent in Botswana (Mehran *et al.* 1998).

6 The speed and sequencing of financial reform

It is generally agreed that macro-economic stability is critical to financial health; cross-country evidence shows that achieving macro-stabilization before or during financial reform controls an important source of financial instability (Demirguc-Kunt and Detragiache 1999: 327). On this score, Ethiopia has done well. Despite the Fund's criticism of the pace of financial reform, its July 1999 Article IV consultation with the government commends Ethiopia's '.... remarkable progress in improving macro-economic stability and implementing structural reforms over the last two years, despite the shocks created by heavy terms of trade losses, adverse weather conditions, and the war with Eritrea' (IMF 1999a: 2). Indeed, Ethiopia's macro-economic policymaking is arguably stronger than that of its former cold war patron; Russia's 1998 crisis highlighted the dangerous interaction that can develop between macro-economic instability and the loosely regulated financial system of a transition economy.

Although it is clear that macro-stability must underpin financial reform, the policy debate is far less clear about how far liberalization should go. For sure, Ethiopia's policymakers are very aware of the perils of directed credit and interest-rate ceilings; these depressed savings and reduced investment efficiency under the Derg. This experience informed Ethiopia's termination of sector-specific lending rates in 1994 and its decontrol of lending rates in 1998. But how far and how fast financial liberalization should be taken, and what is the optimal sequence of measures (for example early or later privatization) are still issues open to debate.

The cross-country evidence in the King and Levine (1993) study indicates that financial liberalization, by fostering financial development, may increase long-run economic growth; this appears to validate the McKinnon-Shaw critique of financial repression. But it is now evident that liberalizing the financial system may increase its fragility. Demirguc-Kunt and Detragiache (1999) find, for example, that banking crises are more common in countries that have liberalized and that the risk is greatest in countries with weak institutions. As Brownbridge and Kirkpatrick (1999: 27) note, the demands on supervisors have grown at a much faster rate than supervisory capacity in many countries; deregulation has allowed the rapid entry of new financial institutions many of which, being small and inexperienced, need close supervision.

It is evident that the World Bank is now much more cautious in its advice regarding financial reform than the IMF, and gives more priority to early institutional investment. The Bank's former chief economist, Joseph Stiglitz concludes that '.... the key issue should not be liberalization or deregulation but construction of the regulatory framework that ensures an effective financial sector' (Stiglitz 1998: 16). Caprio (1996: 1) notes that disappointment with financial reform in Africa and the transition economies might be due to perverse sequencing, in particular '... often more visible aspects of reform, such as complete interest rate deregulation, bank recapitalization, or more recently, the creation of stock exchanges, have been pursued before basic infrastructure in finance—auditing, accounting, legal systems and basic regulations—have been prepared'. Caprio (1996: 4) goes on to argue that although regulatory investment is important, it by no means guarantees safe and sound banking; without motivated bank owners, supervision alone is ineffective. Therefore reducing competition in private banking may actually improve financial stability (Caprio 1996: 4). Limiting entry raises the value of bank licenses as well as the discounted value of bank profits. This may motivate owners to behave in a safe and sound manner, thereby ensuring that they remain open to enjoy those profits. Hence, limiting entry into banking can support regulatory investments in ensuring the stability of the financial system, at least in transition's early years.

In summary, differences with the IMF have arisen over the pace and sequencing of financial reform—not over the desirability of reform per se. There are valid arguments in favour of Ethiopia's cautious approach to financial liberalization, and there are considerable social returns to investment in regulatory capacity. This is demanding of scarce human resources, and this institutional capacity certainly cannot be built overnight in Ethiopia, or in Africa's other transition economies.

7 Conclusions

Consideration of financial reform leads to the larger question of what Ethiopia can learn from transition experiences elsewhere. It is now evident that there is no 'one true path' to a market-economy. This much is clear when comparing the diversity of strategies and outcomes among the European and Asian transition countries. Stiglitz (1999) is among many in highlighting the dramatic difference in performance between the FSU and China.

China has avoided ‘big bang’ reform—the rapid privatization and market-decontrol seen in the early years of Russia's transition—in favour of what the Chinese call 'crossing the river by feeling the stones underfoot' (Gros and Steinherr 1995: 109). China reformed agriculture at an early stage and achieved a major expansion in non-traditional exports, but has only recently accelerated privatization. Financial reform has been notably cautious and capital account transactions remain restricted. These controls have facilitated the use of monetary policy and the central bank's performance on price stability is greatly superior to that of Russia (Pomfret 1995: 137). Despite financial inefficiency—serious problems in China's state banks are now apparent—growth has nevertheless averaged 9 per cent a year for twenty years.[4] China's gradual financial reform is therefore one of the 'highly contradictory ingredients' of its economic transition, a strategy that has nevertheless, delivered unprecedented growth (Gros and Steinherr 1995: 108).

That elements of the former command economy can exist side by side with the new private sector is an anathema to proponents of rapid liberalization. However, this strategy—if well implemented—is not as paradoxical as it first seems given that most policy-makers must live with the market imperfections characteristic of a ‘second best’ world. For these reasons, Qian (1999: 6) argues that:

> ... the main lesson from Chinese experience is that considerable growth is possible with sensible but not perfect institutions, and that some 'transitional institutions' can be more effective than the best practice institutions for a period of time because of the second-best principal:

4 In part this is because China's private-sector has successfully relied on self-finance (including that provided by the diaspora) rather than bank or state credit (Gros and Steinherr 1995: 111). In this regard, Ethiopia may enjoy an advantage similar to that of China: it is favoured by a large diaspora with excellent financial and commercial linkages.

removing one distortion may be counterproductive in the presence of another distortion.

Hence, Ethiopia's emphasis on maintaining macro-economic stability—even at the cost of retaining inefficiency in the financial system—may be optimal in the second-best world that characterises Africa's transition economies. However, we must take care not to stretch the point too far. Clearly, much depends on how Ethiopia manages the market-controls that it does retain; in particular how the authorities cope with the rent seeking behaviour which such controls inevitably encourage. Rent seeking, if unchecked, can pervert otherwise well-intentioned strategies transforming them from mechanisms to raise living standards into means for personal gain. Such, after all, was the experience of Africa's transition economies under state socialism. Second, as the Chinese experience shows, a transition economy needs fast growth to tolerate the efficiency losses associated with financial-sector controls (and market-interventions elsewhere). For Ethiopia this means fast rural growth—where poverty is deepest—together with a major breakthrough in non-traditional exports. This in turn implies close attention to improving micro-finance and rural savings institutions to enable communities to participate in growth.

To conclude, financial reform raises complex technical issues over which there is at best partial consensus (Jansen 1990, Vos 1993). Since reform began, Ethiopia has seen considerable reorganization of state banks as well as the entry of private banks and insurance companies. Interest rates have been significantly decontrolled, and interbank foreign exchange and money markets have been established. Simultaneously, regulatory capacity has been strengthened. Financial reform has been gradual, but nevertheless determined. The government has been very aware of the structural and institutional problems that need to be overcome for a market-based financial system to develop. This has at times provoked disagreement with the IMF, but reform experience in Africa and in the transition economies of Asia and Europe demonstrates that there are many paths through transition, some successful, others not. It is to be hoped that other African countries can learn from Ethiopia with its emphasis on macro-economic stability and institution building in the financial sector. The creation of a sound financial system is crucial to transition and reconstruction, and to raising the living standards of Ethiopia's people.

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